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C O N F I D E N T I A L SECTION 01 OF 03 KUWAIT 001183

SIPDIS

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SUBJECT: KUWAIT CONFRONTS GLOBAL FINANCIAL WOES: ARE THERE MORE DOMINOS?

REF: A. KUWAIT 1177
¶B. KUWAIT 1155

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Classified By: Econcouns Oliver John for reasons 1.4 (b) and (d)

¶1. (C) Summary: Amidst the intrigue of Kuwait,s second constitutional crisis of the year, many citizens continue to be concerned by losses on the Kuwait Stock Exchange (KSE) and the liquidity squeeze faced by many of the nation,s 95 investment companies. Additionally, many Kuwaiti investors are vulnerable to the fragile Dubai real estate market. The GoK has the financial resources to deal with the likely impact of the country's current financial "crisis." Political turmoil, however, could have an impact on the GoK's ability to bring those resources to bear efficiently. End summary.

¶2. (C) Most observers regard the country's banking system as relatively strong and insulated from the global financial crisis. They do raise concerns about Kuwait,s 95 investment companies, many of which are regarded as potentially insolvent. Although these firms collectively control USD 66 billion in assets, a handful of companies dominate the sector. The failure of some, or most, of these firms is unlikely to have a systemic effect on the broader economy or financial system. Most observers believe that bailing out these companies would not require significant GoK outlay.

¶3. (SBU) For the time being, Kuwait has pushed its political crisis down the road, allowing Kuwaitis to return their attention to financial issues. The KSE is down about 30 percent year-to-date and over 55 percent since its June high. The country's third largest lender, Gulf Bank, would have failed absent government intervention and a negotiated bailout. These events, along with the global financial crisis, and falling oil prices have finance professionals looking for the next domino to fall.

AILING INVESTMENT COMPANIES

¶4. (C) Many of our financial sector contacts argue that a majority of Kuwait's 95 (45 conventional, 50 Islamic or "Sharia compliant") investment companies are "under water." The general belief is that the top tier investment companies, such as Global Investment House or Noor Investment, are likely to survive. Some of the smaller ones would likely need some kind of bail out; and the smallest may be allowed to collapse quietly.

¶5. (SBU) In an effort to see where the problems might lie, post examined consolidated Central Bank data on the investment companies. Although this disguises the very real differences in size and asset allocation among the firms,

some of the figures indicate where the problems might lie. As of the end of October, the investment companies managed around USD 66 billion in assets, making them about seventy percent as large as the local commercial banking sector. Around a quarter of their assets are in domestic financial investments. Given the 10 percent drop in the stock market since the end of October, these investments could have dropped in value by as much as USD 1.8 billion. On aggregate, these companies are also vulnerable to the global (and regional) financial downturn since foreign investments make up around 45 percent of the portfolio of conventional investment companies and 31 percent of the portfolios of Islamic investment companies. On the funding side, about a fifth of investment company liabilities are foreign. Given the retrenchment of international investors and sharp cuts in international lending, their access to funds is vulnerable to the current "flight to quality." This all leaves the sector with a potential liquidity shortage. (Comment: The consolidated figures show heavy exposure to the domestic stock market and to foreign investments. Anecdotally, Kuwaiti investors are heavily invested in the Dubai property market, but what percentage of the investment company balance sheets this makes up is unclear. End Comment.)

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Dubai
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¶5. (C) Kuwaiti investors have been heavily invested in the Dubai real estate market and several major Kuwaiti companies also have exposure to the Dubai bourse. Given the public perception of Dubai's heavy leverage and the impending bursting of its real estate bubble, Kuwaiti investors are concerned about the level of their exposure. Nasser Al-Marri, Managing Director of Noor Investment, told econoffs

that Noor had closed out its Dubai exposure in August and was now looking at opportunities in Abu Dhabi and Saudi Arabia. Kuwait's financial exposure to Dubai has triggered the interesting rumor that Dubai has approached Kuwait (whether the GoK or private investors is unclear) about bailing out the emirate. As one Kuwaiti investor reportedly said, "why not, we need to protect our investment." Although there is precedent, the GoK is likely to focus its initial efforts on bailing out the domestic market.

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WHAT ABOUT THE COMMERCIAL BANKS?
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¶6. (C) The general consensus among financial professionals is that the commercial banking sector is in generally good shape. With the exception of Gulf Bank, Kuwait,s banks appear to be relatively insulated from bad derivatives contracts and other troubled assets. All the banks and the Central Bank have been actively looking at off balance sheet activity in the wake of Gulf Bank's collapse. Their direct exposure to the non bank financial sector (which includes investment companies as well as insurance and exchange companies) is only about 13 percent of their total assets (or USD 10.6 billion). This equals their personal loans for individuals to purchase stocks. Bank exposure to the real estate market makes up about a quarter of their portfolio. So far, however, this sector remains resilient. According to Adil Ahmed, the president of Kuwait International Bank, historically Kuwait,s leading real estate bank (and now an Islamic bank), property values in nearly all neighborhoods within the sixth ring road of Kuwait City have remained steady this year. Al-Marri noted that while demand for real estate may be down, there is no supply, hence prices remain stable. (Note: The GoK owns most property in Kuwait and has been slow to release it to the general public. End note.)

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GOK RESPONSE?

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¶7. (C) The GoK has taken a number of steps to stabilize the financial markets, including guaranteeing all bank deposits, orchestrating a rescue package for Gulf Bank, and announcing the establishment of bailout funds for both the KSE and the investment companies (with the Kuwait Investment Authority, Kuwait,s sovereign wealth fund, acting as buyer of last resort). Combined, these actions create billions of dollars of contingent liabilities; however the overall problem appears manageable. After several years of high oil prices and budget surpluses, the GoK has a cushion. KIA is estimated to have around USD 264 billion in assets. (Note: According to KIA Executive Director Ahmed Al-Bastaki, KIA would use the General Reserve Fund, not the much larger Fund for Future Generations to stabilize the market. According to press reports, KIA has repatriated almost USD 4 billion in recent months to invest in its domestic market. End Note.) Naser Al-Marri, Managing Director of Noor Investment estimates that the GoK could stabilize the stock market, recapitalize investment companies, and maintain liquidity in the banking sector with about USD 10 billion. Samer Khanachet, the chief operating officer of KIPCO Kuwait Projects Co., described the current financial situation as a &tempest in a teacup,8 given the ease with which the GOK can allocate a small proportion of KIA,s assets to stabilize all sectors affected by the global financial crisis. At least a dozen other leading financiers in Kuwait have voiced similar sentiments to econoffs.

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COMMENT
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¶8. (C) Comment: Unless Kuwait's financial woes are far worse than anyone suspects, it appears that the GoK has the resources to ensure that the systemic impact of the stock market fall is limited. Given the government's control over much of Kuwait's vacant land, it can manipulate supply to keep it below growing demand and minimize the chances of a price collapse. The GoK has also publicly committed to protecting the economy and)- on the rare occasions that the GoK and the National Assembly worked together)- quickly passed a deposit insurance bill. Governmental paralysis, however, could weigh on a near-term recovery and, in the worst case, significantly raise the cost of any rescue. Executive-legislative relations had deteriorated to the point where most Kuwaitis assumed the National Assembly would be dissolved. Instead, the government submitted its resignation and it appears as if the National Assembly will delay its next session until sometime in January. End comment.

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JONES